WHITFORD ADVISORY SERVICES LLC
Professional Advice for Serious Investors

What a Tangled Web the Fed Has Weave

Index	May 2016	YTD
Russell 1000	**1.75**	**3.51**
Russell 2000	**2.25**	**2.28**
MSCI – EAFE	**(0.91)**	**(1.10)**
MSCI – Emerging	**(3.73)**	**2.32**
S&P 500	**1.8**	**3.6**

Source: Russell, MSCI and Standard & Poor's

Table I: Global Equity Market Returns -%

The U.S. equity markets had strong performance led by technology, health care and financial sectors. The international markets were not as fortunate. Of interest is the 12-month and 24-month returns for the S&P 500 which are essentially flat. The various emerging markets while negative for May have been very strong in in the past 3 months. Longer term (12 months) the emerging markets have been very painful for investors.

Economics and Policy

The global economy has a faint pulse. Leverage is again exploding as government spending (and deficits) has grown. In this environment of negative interest rates and quantitative easing distorting asset prices, a slow realization is coming into focus that Keynesian fixes for the economy are monumental failures. As a result of monetary policy being exhausted we are seeing a rise in political gridlock and rising populism, which is leading to violence and massive migrations.

As a result of high government spending that has inflated entitlements and benefits, defaults and bankruptcies are becoming more commonplace. Puerto Rico, as an example, has defaulted on $422 million of its municipal bonds as a result of decades of massive government spending, high taxes and high unemployment (40% labor participation rate). Venezuela is in the midst of another experiment in socialism going up in smoke. The collapse of oil prices has strained the government's ability to spend. As a result, electricity, food and everyday necessities are rare while rioting has taken over daily life and martial law the new governing policy.

The U.S. Presidential election with all its mudslinging is now at full speed as both parties' head toward their conventions. In addition, there is Central Bank drama. Central Banks are on edge as the referendum on June 24 in Great Britain nears. The vote will determine whether Great Britain leaves the European Union"EU". This vote along with Federal Reserve policy will have a heavy impact on the U.S. election. There is global fear that the vote to withdraw from the EU will result in another financial crisis and recession.

In the U.S. the debate over the economy continues. We are now about 7 years since the U.S. officially was no longer in a recession however to many folks it still feels like a recession. The administration keeps championing all the jobs created and the 4.9% unemployment rate. The most recent jobs report exposed the weakness of that stance as May produced 38,000 new jobs, the lowest in nearly 6 years. Of that 38,000, 11,000 were government jobs. An analysis of the job report showed 10,000 jobs above the median pay level were lost while 34,000 added were below the median pay level. The proposed solution of raising the minimum wage to $15.00 will only worsen the problem while giving the veneer that something is being done. Ignored is the fact the minimum wage affects less than 4% of the workers of which one-third are teenagers.

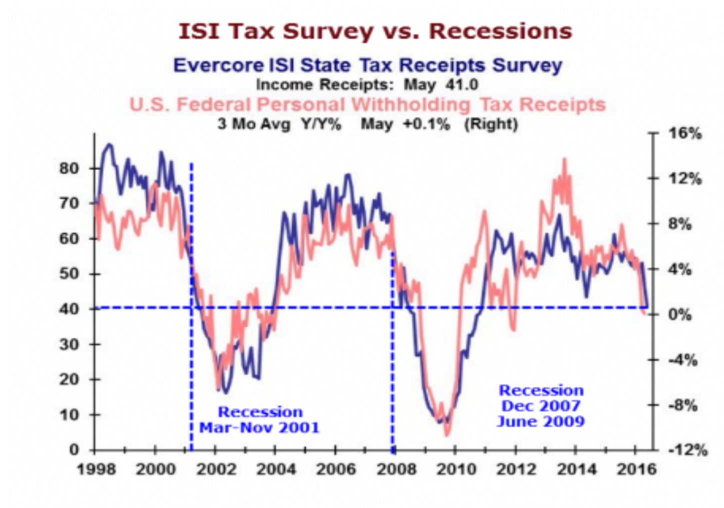
In addition to the soft job picture, echoes of 2007-08 are beginning to surface. Underwriting standards have been lowered again and the administration is forcing a diversity requirement to bank lending. Sub-prime lending in the auto sector is also growing sharply. In the commercial side of lending, non-performing loans for Commercial & Industrial sector has risen form 0.79% in 4Q2015 to 1.29% at the end of 1Q2016. Early indications suggest that number continues to rise.

The manufacturing sector is still weak. Industrial Production for May 2016 declined -0.4% and down -1.4% year-over-year. Capacity Utilization also declined -0.4% in May and remains 5.1% below its long-run average (1972-2015).

The Federal Reserve, which has provided nearly100 months of zero interest rates, has abruptly switched course or at least its public rhetoric. These low rates have spawned speculation in the equity markets and have arguably created an asset bubble. Concurrently, the zero rate policy has crushed savers. To be blunt zero interest rates has done nothing but confiscate a portion of an investor's capital and stunted economic growth. It was expected that the Federal Reserve would begin to nudge rates up at its June meeting. The Federal Reserve has stayed its interest rate policy at its recent meeting, apparently shocked by May jobs report. Fed Chair Janet Yellen however remarked the labor market "healthy" but needed to be monitored closely. The fear bankers face is an equity market crashing in an election year. It is apparent to most observers of the economy that the Keynesian fix has failed. The U.S. and Japan policies show that a new tact needs to be taken. Japan, for 25 years. has used zero interest rates and government spending in attempts to resuscitate its economy. One possible scenario is the Fed, in order to give it some wiggle room, may do a small bump in rates if Britain exits the EU. The expectations of a market sell-off from Brexit will provide the Fed a scapegoat for its sudden change in policy.

The probability the U.S. will slide into another recession in 2016-2017 has increased dramatically. Employment, GDP growth and overall economic activity are stagnant. One interesting indicator is the ISI Tax Survey vs Recessions (Chart I.). A 3-month moving average of tax receipts shows a strong correlation that a recession is imminent with a slowdown in tax collections.

Chart I. ISI Tax Survey vs. Recessions



Source: Evercore

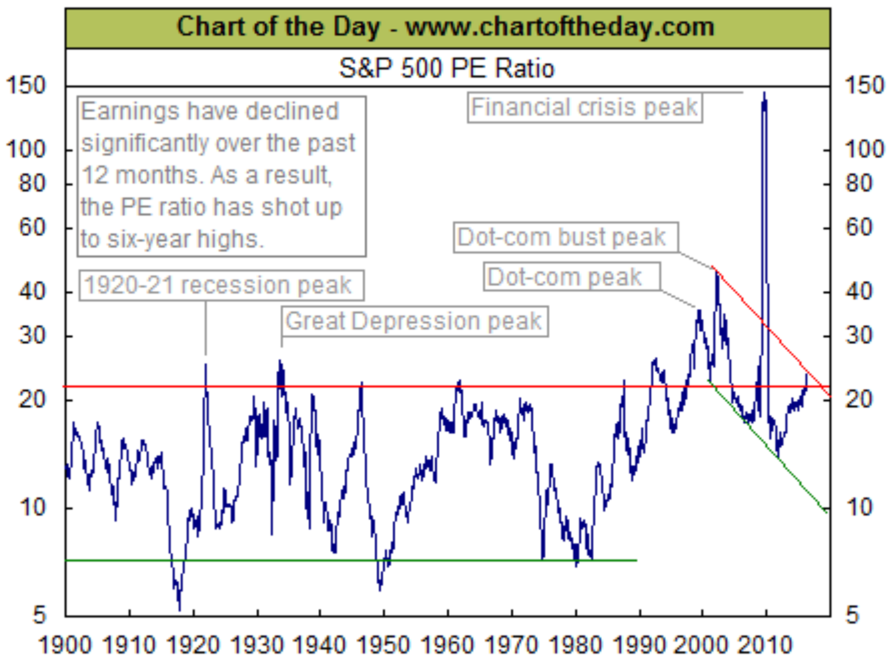
A silent drag on the economy that is creating another divide between political parties is the emergence of terrorism. Especially disheartening for the economy is there appears to be a serious disconnect in our administration's policies and the reality the country is experiencing. The debate is being twisted from the growing problem of terror to one attacking the 2nd amendment. Leaving gun control debates aside, there seems to be a more disturbing issue. After the recent Orlando terror attack, President Obama spoke of how ISIS was largely controlled. This was in direct opposition to the Congressional testimony CIA head John Brennan delivered in the same week.

Emotions are already running high as the U.S. gears up for the most contentious election since the 1960's. The immigration and the terrorism threats have merged creating concern for the economy and tensions sparking civil unrest. A very under-reported comment by former Fed Chair Alan Greenspan might give one pause. In a TV interview, he commented that, as we mentioned above, Venezuela is under martial law. He also pointed out that this could ultimately take place here in the U.S. Unlike Venezuela, which imploded due to poor economic policy, Greenspan chose to absolve the Central Bank and central government of any responsibility for the U.S. decline and instead blame a "global problem of a shortage of productivity growth." A much more high-minded excuse without holding anyone accountable.

Investments

We are increasingly more skeptical of a continuing positive equity market environment. Valuations are stretched even by the most generous analysis. As seen in Chart II. below, the S&P 500 PE ratio is now in territory of other major stock declines. Based on Price-to-book measures, investors are paying dearly for consumer staples and technology stocks; selling well above their 10-year average. Energy (For obvious reasons) and financials are the only sectors selling below their 10-year average.

Chart II. S&P 500 PE Ratio



The artificial interest rate environment masks the true level of risk that may be inherent in any new purchase of government, public corporate debt or municipals. High yield bonds due to their attractive yields continue to attract investors. We would caution that rate increases and extended leverage may add unexpected volatility.

It should come as no surprise to readers for the past several years that we expect an equity sell-off of 20-30% accompanied by intensifying protests, rioting and generally unrest caused by failed economic policies and excessive government spending and taxes. It is critical for investors in order to protect/hedge their capital in this very uncertain environment.

Last month we commented that a 5-10% allocation in precious metals primarily gold and silver might be a prudent investment for the upcoming months. Central banks continue to be large buyers of gold. Gold and silver have risen over 20% this year. (Note: Price of Bitcoin up 60% in the last 3 weeks)

For those who require higher streams of cash flow, there are reasonable risks: return profiles in private equity deals. These can offer double-digit interest payments with possible equity exposure without the volatility of the public markets.

We also have suggested farmland as an alternative to more traditional real estate over the past several years. Although price increases have moderated a bit, demand by ultra-high net worth investors has not subsided. Of particular interest are irrigated properties. Global food concerns along with other economic concerns should continue to attract attention to farmland investing.

We are heading for very untraditional times that will require non-traditional ways to protect capital.